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Mitterrand's Economic Management: Have the Lessons Been Learned?

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An Intelligence Assessment

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December 1983

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Mitterrand's Economic Management: Have the Lessons Been Learned? [redacted]

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An Intelligence Assessment

This paper was prepared by [redacted]
Office of European Analysis. Comments and queries
are welcome and may be directed to the Chief,
Western Europe Division, EURA, [redacted]

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Mitterrand's Economic Management: Have the Lessons Been Learned? [redacted] 25X1

Key Judgments

Information available as of 1 December 1983 was used in this report.

The biases and miscalculations of the Socialist-Communist government formed under President Francois Mitterrand in 1981 aggravated an already bad economic situation. The government:
- Worsened a serious deficit with a strongly expansionary budget.
- Enacted a costly nationalization program.
- Instituted tax and labor measures that shook the confidence of management.

The program was a failure, marked by continuing high inflation, mounting trade and payments deficits, and three successive devaluations of the franc.
[redacted] 25X1

Faced with serious economic problems, Mitterrand chose the classic economic remedies—reducing domestic liquidity and slowing economic activity—recommended by his principal economic advisors over the more radical solutions advocated by his Communist coalition partners and the left wing of his own party. The left wing urged:
- High-growth and jobs-oriented policies.
- Tighter controls on prices, wages, and capital movements.
- Protectionist barriers against foreign competition.
- Withdrawal from the European Monetary System, considered to represent the subordination of national goals to international commitments.

[redacted] 25X1

Austerity measures introduced in June 1982 and tightened significantly in March 1983 have brought the policies of the French Government into line with those of its major Western partners. They provide for:
- Reduced household consumption through higher taxes and a forced loan to the state.
- Slower growth in government and public-sector outlays.
- Lower monetary growth targets. [redacted] 25X1

Mitterrand's turn toward austerity has been politically costly. The coalition parties have lost a series of local elections and have declined in public opinion polls. The evidence indicates that the government has lost support from both leftists and the moderates whose backing was responsible for Mitterrand's margin of victory in 1981. [redacted] 25X1

Pressure for an easing of the austerity program is likely to mount in coming months as workers resist further reductions in their real wages. We believe, however, that the government is likely to stand firm at least for the next 12 to 18 months:

- It has made substantial progress in reducing the trade deficit, and it is likely to have at least modest success in lowering the rate of inflation.
- Trade unions and workers will be reluctant to bring down a leftist government.
- The Socialists command a majority in the National Assembly and do not face new elections until 1986, while Mitterrand's term runs to 1988.

[redacted] 25X1

Achieving a lasting solution to France's fundamental problems—a growing external debt burden, a chronically weak franc, and lagging industrial competitiveness—will depend on maintaining present policies for a prolonged period. [redacted] 25X1

We are relatively optimistic on this score, even though the record of French politicians in resisting the siren call of political expediency is not good. We believe that Mitterrand and other senior policymakers have been chastened by their early mistakes and now have an appreciation of the need to continue their present economic program. [redacted] 25X1

The United States has a strong interest in a stable France and the success of Mitterrand's moderate economic policies. Failure might well lead to:

- Increased influence for the advocates of nationalist and protectionist policies and a weakening of the moderate left.
- The weakening of France's economic ties to its major trading partners.
- A diminished French ability to contribute to the defense of the West.

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Mitterrand's Economic Management: Have the Lessons Been Learned? [redacted] 25X1

A Vision of Limitless Horizons

The presidential election in May 1981 brought the French left into government for the first time since the establishment of the Fifth Republic in 1958. Francois Mitterrand's victory over incumbent centrist President Giscard d'Estaing generated near-delirious optimism among supporters of the Socialist-Communist electoral coalition. The magnitude of the victory appeared even greater in June when the Socialists won an absolute majority in the National Assembly, giving the new government (with four Communist ministers out of 44) the political strength to transform Mitterrand's ambitious campaign platform into reality. [redacted] 25X1

In many ways the leaders of the left were ill prepared for power. Few of them had had governmental experience at the policymaking level. They were encumbered by unrealistic ideological prescriptions for France's real and imagined ills, which most of them took quite seriously. [redacted] 25X1

This paper assesses the Mitterrand government's track record to date. After briefly addressing the early profligacy of the Socialist-Communist coalition, it reviews the debate that led to an abrupt change of course and then analyzes the economic and political costs of austerity. Finally, it looks at prospects for economic policy and the economy. [redacted] 25X1

Early Miscalculations and Their Consequences

By all accounts, the Socialists were convinced that a party that had won office on the basis of a call for "change" would rapidly lose support if it introduced economic and social measures that were only cosmetic. Anxious to avoid this pitfall, they were driven to redeem their promises, but hindsight shows that they failed to appreciate how narrow their maneuvering room was in several critical policy areas. They also unrealistically assessed the impact of external conditions on domestic policy choices. For instance, they assumed that a worldwide recovery was just around the corner and that a stimulus program to boost

Chronology

May 1981	*Mitterrand elected President.*
	Mauroy appointed Prime Minister.
June 1981	*Socialist Party gains absolute majority in National Assembly election.*
	Prime Minister Mauroy forms coalition government with Communist participation.
October 1981	*First devaluation of the franc.*
February 1982	*Nationalization bill finally becomes law.*
June 1982	*Second devaluation of the franc.*
	"Rigor I"—wage/price freeze in effect.
October 1982	*Freeze lifted at end of month.*
March 1983	*Heavy Socialist and Communist losses in nationwide municipal elections.*
	Third devaluation of the franc.
	"Rigor II" — economic austerity.
October 1983	*Biennial Socialist Party congress approves Mitterrand's economic policies.*

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The Economic Inheritance

The economic record of the Giscard administration (1974-81) was mixed. 25X1

The positive elements afforded the Socialists advantages in several critical areas:

- *The public-sector accounts had, in general, been prudently managed. Public debt remained roughly stable as a percentage of GDP.*
- *Foreign exchange reserves had been built up substantially by the end of Giscard's term.*
- *Despite the tendency of the current account to fall into deficit as the cost of energy imports soared, the government had been quick to institute adjustment measures.*
- *Although the government resorted to foreign borrowing by public-sector firms both to finance their expansion and to cover balance-of-payments shortfalls, gross guaranteed foreign debt of nearly $25 billion [a] at the end of 1980, according to the International Monetary Fund, did not present a servicing or repayment problem for the state.* 25X1

The negative elements left France's industrial structure financially weaker and less competitive:

- *Unemployment rose steadily.*
- *Mitterrand inherited an inflation rate of 13 percent. Although fighting inflation was an acknowledged priority, the Giscard administration was reluctant to attack it head on by, for example, directly challenging the nearly universal custom of wage indexation.*
- *Giscard made little effort to trim increases in welfare costs, choosing instead to raise taxes and social security contributions.*
- *Giscard allowed much of the additional fiscal burden to be borne by French businesses, with the result that profitability declined and productive investment stagnated.* 25X1

The economic inheritance also included traditions and structures that Giscard himself found in place in 1974. Among these were:

- *State involvement in the economy—known as* dirigisme*—a hallmark of which is the government's tendency to intervene in decisionmaking in search of results it considers desirable.*
- *State ownership or effective control of a number of major industrial firms—the result of two previous waves of nationalization in 1936 and 1945.* 25X1

[a] At the December 1980 exchange rate of $1 = FF 4.57. The franc equivalent was 112.9 billion. 25X1

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domestic economic growth would not place France too far out of phase with its principal trading partners. Further, they disregarded recent French experience by assuming that a stimulus program would not significantly boost import demand. 25X1

The Socialists' miscalculations led them to worsen an already deteriorating economic situation by:

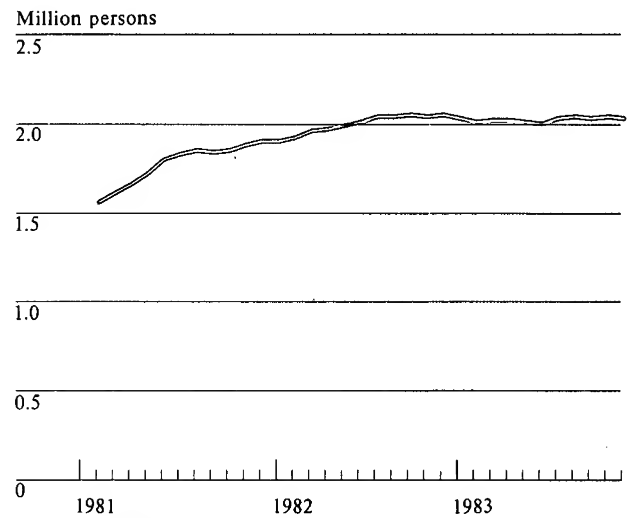
- Expanding the serious 1981 budget deficit they inherited and accepting an even larger deficit in a strongly expansionary 1982 budget.
- Pushing ahead with a divisive and costly nationalization program.
- Instituting tax and labor measures that reduced entrepreneurial and managerial incentive and heightened the business community's already strong skepticism of a Socialist government.
- Underestimating the difficult financial situation of many French businesses.
- Paying insufficient attention to the implications for long-run balance-of-payments equilibrium of the rapid buildup in foreign debt that began with increased trade deficits and efforts to defend the franc. 25X1

Contrary to the hopes of the Socialists, the increased purchasing power injected into the economy did not go largely to purchase French goods, thus inducing an investment pickup. French producers were not in a position, for the most part, to supply the durable goods that consumers wanted to buy. Nor were producers able or willing to boost capital spending. Declining profits had already left most of them with diminished cash reserves, and government-mandated increases in costs—including a reduced workweek at full compensation and higher social security charges—unquestionably worsened their situation. In addition, the major industrial firms scheduled for nationalization contributed little to investment, as the lengthy process of enacting the contested nationalization law created a climate of uncertainty in executive offices. Although foreign investment in France did not come to a halt, many foreign firms undoubtedly adopted a wait-and-see attitude about the desirability of new projects. [redacted] 25X1

The somewhat higher level of domestic activity resulting from the stimulus program contributed to stabilizing unemployment (see figure 1) after mid-1982, but only at the cost of expanded budget deficits that the Treasury could not finance without resorting to greater money creation. Consequently, consumer prices edged upward to an annual rate of about 14 percent during a period when inflation in France's major trading partners was subsiding rapidly. [redacted] 25X1

In addition to sustaining inflation, the stimulus program was a failure in other respects. Mounting trade deficits, in combination with stagnating receipts in the normally surplus services account and large outward capital movements by French and foreign investors nervous over Socialist intentions, produced massive balance-of-payments deficits during late 1981 and the first half of 1982. External borrowing increased at a rapid rate, occasioned by the need both to cover the shortfall and to defend the franc's parity in the European Monetary System. Foreign confidence in the Mitterrand government plummeted. The decline of the franc provided the most graphic evidence of the failure of Socialist economic policies. Three devaluations followed in rapid succession—in October 1981, in June 1982, and in March 1983. The Socialists were able to attribute some of the responsibility for the first

Figure 1
France: Unemployment[a]



[a] Number of registered job seekers at end of month, seasonally adjusted.

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devaluation to the Giscard government, but the next two were unquestionably the product of their own errors. [redacted] 25X1

The Policy Debate

The conventional cure for the problems the French franc and the economy experienced after the first year of the Mitterrand government was to reduce domestic liquidity and slow economic activity. The decision to adopt such policy measures, however, posed particular problems for a government of the left. Mitterrand was confronted with a choice between sacrificing elements of his program—such as higher growth levels to reduce unemployment—or risking a weakening of

France's ties with the EC and the world trading system. In the end, he opted for a cautious austerity, which was followed up with bigger doses in later months.

Policy Differences

Most key members of Mitterrand's government believed that it was not practical to try to recreate a more autarchic France and that the ramifications of domestic economic choices on relations with France's principal allies and trading partners should not be disregarded. According to French press accounts, Prime Minister Pierre Mauroy; Finance Minister Jacques Delors; key members of the presidential, prime-ministerial, and Finance Ministry staffs; Bank of France President Renaud de la Geniere; Treasury Director Michel Camdessus; and former Treasury Director and Paribas Bank President Jean-Yves Haberer were among those who warned against changing France's fundamental political and economic orientation. Mitterrand intimate Laurent Fabius, who was then Budget Minister and later became Industry Minister, reportedly became strongly convinced of the correctness of this group's views and played a key role in influencing Mitterrand.

Both Mitterrand's Communist coalition partners and leftist elements within the Socialist Party advocated another course. These proponents of an "alternative" policy pushed for a nationalistic approach featuring higher growth and continued emphasis on reducing unemployment. In keeping with leftist principle and their interventionist inclinations, they believed, according to press reporting and public position papers, that a major role for the state would be necessary to ensure that these priorities were maintained and budget resources made available. They favored tighter controls on prices, wages, and capital movements to minimize the impact of budget deficits and contain inflation. They also favored greater protectionism to shield domestic producers from foreign competition. Finally, they wanted France to drop out of the European Monetary System, which they saw as a symbol of the subordination of national goals to those of other European governments, notably Bonn.

The motivations of the Communist and Socialist advocates of an "alternative" course probably differed. The Communist Party (PCF) presumably was interested in pursuing its long-term goal of detaching France from its ties with Western economic and security organizations, such as the European Community and NATO. In addition, the Communists are little concerned with questions of economic efficiency and have consistently espoused autarchic policies. The approach of the leftwing Socialists, led by then Industry Minister Jean-Pierre Chevenement, was more complicated. They were willing at least to concede the desirability of a European dimension to French policy—as long as it could be on French terms. They argued publicly that the European Community should adopt a policy of faster growth and agree on an arrangement for adjusting EMS parities regularly to take inflation differentials into account. They also advocated "short-term" protectionist measures, such as safeguard clauses, quotas, and orderly marketing agreements. The distinction between them and the openly autarchic Communists was blurred by the Socialist faction's admission that protectionism would be necessary until French industry could once again be fully competitive in world markets. According to press reports, some of Mitterrand's personal advisers—Schlumberger President Jean Riboud, journalist-philosopher-politician Jean-Jacques Servan-Schreiber, and IndoSuez Bank President Georges Plescoff—also argued for strong measures to deal with the trade deficit, proposing the use of protectionist devices available under EC and GATT rules for limited periods of time.

Easing Into Austerity

Although the government began to apply a "conventional" solution with the second devaluation in June 1982, it was still mindful of its commitment to reduce unemployment and was reluctant to slow economic activity too abruptly. Illustrative of the new approach was the replacement in late June of ardent leftist Nicole Questiaux as Minister of National Solidarity (social welfare). Her successor was Pierre Beregovoy, a Mitterrand loyalist who was charged with bringing the social security accounts back into balance by increasing revenues and tightening up on expenditures. Mitterrand also confirmed an earlier injunction that the 1982 and 1983 budget deficits were not to exceed 3 percent of GDP. In addition, the government

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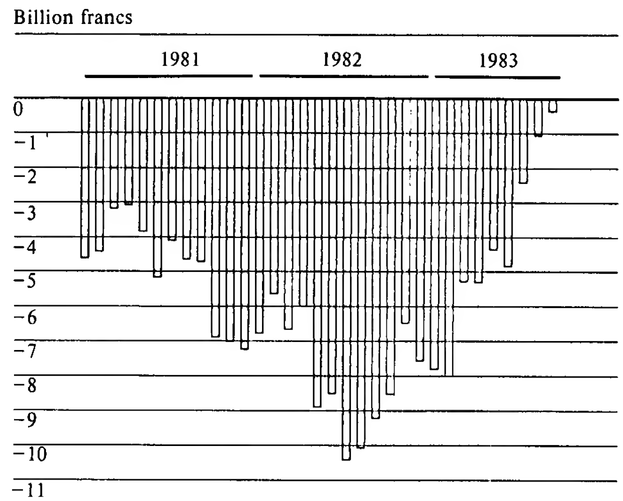
froze most prices and wages for four months in order to bring a quick reduction in the rate of inflation. In an attempt to modify the almost universal practice of indexation, the government elaborated a plan to tie programed wage increases in the public and private sectors to projected rather than actual rates of inflation. The freeze did slow inflation, but improvement in the trade balance was less than had been hoped. This was attributable in part to a sizable increase in real household consumption during the period. Savings were drawn down, and transfer payments offset for many households the effect of the freeze on real wages. 25X1

It took the even greater shock of a third devaluation in March 1983 to persuade the Mitterrand government to produce a program with a good chance of achieving results (see figure 2). New measures put into effect provided for significant reductions in domestic spending by both government and households. The methods used were tax increases, a forced loan to the state, public utility price hikes, an additional tax on petroleum products, and cuts in government and public-sector outlays. In addition, monetary growth targets were lowered, and credit controls were made more restrictive. The intent this time was clearly deflationary. The government recognized that its actions could trigger a recession and would make higher unemployment inevitable; but balancing the external accounts and keeping downward pressure on prices had to come first.

Figure 2
France: Trade Deficit, 1981-83[a]



[a] F.o.b.-f.o.b., seasonally adjusted, 3-month moving average.

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The Rationale

There were widespread reports that Mitterrand, who is reputed to have little interest or expertise in economics, was attracted by some of the leftist arguments and was only reluctantly persuaded to go along with Mauroy, Delors, and their supporters. There were compelling political reasons for his choice. First, previous governments of the left in France—notably Leon Blum's Popular Front in the 1930s—had earned a reputation for mismanagement of public finances. We believe that Mitterrand, anxious about his own historical reputation, did not want his name associated with a similar failure. Mitterrand also undoubtedly realized that an economically enfeebled France—the probable consequence of economic isolationism—would find its overall international influence and its ability to pursue its interests diminished. His record suggests, moreover, that Mitterrand also believes a commitment to the European Community and to the world trading system ultimately serves French security interests, as the political isolation that would follow radical economic measures certainly would not. 25X1

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There were also sound economic reasons for Mitterrand to decide as he did. If the EMS were abandoned and the franc floated, the drop probably would have been beyond the government's power to reverse. A steep decline in the franc's value, by adding to the cost in francs of imported goods, would have pushed up inflation, countering the government's efforts to reduce it. More fundamentally, import controls to avoid this could only be partially successful, given France's requirement to import nearly all its energy and large quantities of raw materials. Protectionism would also lead inevitably to retaliation against

French exports. In these circumstances, the benefit to the trade deficit would be problematical. In addition, such policies could result in closing foreign markets to the very industrial sectors that the Socialists wanted to develop through the nationalizations and a more vigorous industrial policy. [redacted]

The Impact of Austerity

For the majority of the French, the austerity program's sharpest impact was in terms of declining real income. French workers had experienced steady gains in purchasing power during the period of rapid economic growth that began in 1960, and most of them had come to consider such gains a job perquisite. Moreover, very few would have expected a government of the left to call the "principle" into question. [redacted]

The economic shock of austerity rapidly entailed significant political costs. The coalition parties suffered a setback in nationwide municipal elections in March 1983 and since then have endured a series of embarrassing reverses in local elections. Until recently—when public approval of Mitterrand's actions in Lebanon and, to a lesser extent, Chad appear to have reversed the trend—the popularity ratings of Mitterrand and most other Socialist leaders drifted steadily downward in public opinion polls. The evidence is that the shift toward austerity has cost the Mitterrand government support among its own constituency on the left, while failing to win back the crucial support of moderate swing voters disenchanted by the early excesses of the Mitterrand government. As a result, Mitterrand has had to contend with sporadic criticism from the left wing of his own party, an increasingly fractious Communist ally, and manifestations of labor and public unrest. [redacted]

Regaining moderate support, which had been slipping even before the change in economic policy, will be difficult for Mitterrand. Many moderates voted against Giscard in the expectation that not much of the Socialist platform would be carried out. For them, Mitterrand's first year—with its prodigality and initiatives such as the nationalization program—was an unpleasant surprise. The austerity program, however, has probably done very little to win them back. Many of those who opted for Mitterrand are middle class white-collar or middle-management employees. The government's tax-raising measures have hit them hard, and they have not benefited from the breaks accorded lower income workers. The government has also had to confront a rising sentiment among these former supporters that it is fumbling and incompetent. In October, for example, protest demonstrations sponsored by the union that represents many white-collar employees took on an unaccustomed political and antigovernment tone. [redacted] 25X1

The Socialists have consistently referred to the economic policy now in effect as "rigor" rather than austerity or deflation. This verbal sleight of hand is intended to ward off leftist criticism that the government is pursuing conservative policies and to reassure leftist constituents that fundamental goals, such as reducing unemployment and promoting greater equality, have not been abandoned. This rhetoric has not been persuasive, however, and some longtime leftist voters have become sufficiently disillusioned to stay home on election day or even to vote for opposition candidates. These trends have begun to affect the Socialist Party as much as the previously more vulnerable Communists. They concern Socialist strategists, according to Embassy reporting, even though they do not concede that the voters are irretrievably lost to the left. [redacted] 25X1

The struggle over the choice between "rigor" and the "alternative" also contributed to a resurgence of Socialist Party factionalism. The dispute broke open after Chevenement's departure from the government in March, when he and his principal lieutenants in the CERES faction [1] began to speak out at party gatherings and in the press. Mitterrand's effort to stay above the battle and avoid committing himself fully and openly to the austerity program suggested a lack of conviction about it and lent credibility to the CERES attack. [redacted] 25X1

[1] CERES is the French acronym for the Socialist Research and Study Center, the group that claims the allegiance of most members of the party's left wing. [redacted] 25X1

Chevenement became less aggressive after Mitterrand began to speak out forcefully in support of austerity, and some local party officials charged that Chevenement's criticism verged on disloyalty. Nonetheless, he submitted his "alternative" as a motion for consideration at the Socialist Party congress in October 1983 and won 18 percent of the overall vote (including a majority in a few federations). In the final voting, a potential embarrassment was avoided when Mitterrand got the unanimity he wanted in exchange for some minor concessions to CERES. [redacted]

The existence of dissent on the Socialist left probably encouraged the Communist Party to step up its public criticism of the government's economic policy. Although the PCF has not wanted to bear the onus for breaking the coalition and has gone along with austerity, it has not wanted to be outflanked on its left by CERES and has sought to keep its constituents aware that it prefers the "alternative" policy. Party spokesmen have blamed the decline in the left's popularity on the government's failure to persevere with the expansionist, distributive policies of 1981. In recent months, however, Mitterrand and the Socialists have become increasingly angry over this PCF tactic, which accompanies PCF sniping at the government on foreign policy issues such as INF, Lebanon, and Chad. The disappearance of overt CERES opposition to the government's policies probably will reduce the PCF's maneuvering room, a likelihood the party seems to have grasped early. The PCF has signaled its intention to redirect its attacks toward the opposition and the French Employers' Association, but the harsh tone of recent Socialist criticism of the PCF suggests that Mitterrand and the Socialists are likely to insist on more positive Communist support for austerity in the coming months. [redacted]

Opposition political leaders have been relentlessly critical of the government's policies. Given the low priority the French accord civility in political discourse, their criticism has been characteristically harsh, and at times they have implied that a collapse of the government and Mitterrand's early departure from office would hardly be unexpected events. This tactic was probably useful in rallying party militants discouraged by the leftist landslide of 1981, but it also contributed to a climate of rising social tension and political polarization that, we believe, alienated many thoughtful Frenchmen. Perhaps in response, the scenario of impending chaos has been downplayed recently by opposition leaders, who have shifted their attention to the National Assembly election scheduled for 1986. [redacted] 25X1

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Current Prospects

The Mitterrand government's early excesses and the obvious reluctance of some Socialist leaders to accept the need for "rigor" have raised many questions about the durability of the Socialist commitment to moderate economic policies. We believe, however, that Mitterrand will be able to point to enough progress on the economic front, especially in reducing the trade deficit, to deflect the pressures to ease up on the austerity program. In particular, the government's efforts to limit progressively nominal wage increases as a means of reducing inflation are likely to generate resistance. [redacted] 25X1

Political Tactics

The political benefits of sticking with the austerity program are compelling. The Socialists' sights are set squarely on the 1986 legislative elections, as they have been since embarking on their program to reverse the damage done by their initial economic policy decisions. They have a breathing space of at least a year before political necessity will force them to consider reflationary measures. On the other hand, it is essential for them to hold the political center in 1986. Their chances of doing so are slim if they are open to 25X1
charges of economic incompetence. In our judgment, Mitterrand's strong, if belated, personal support for the austerity program and its ratification at the Socialist Party congress also indicate that a reconsideration is unlikely during 1984. [redacted] 25X1

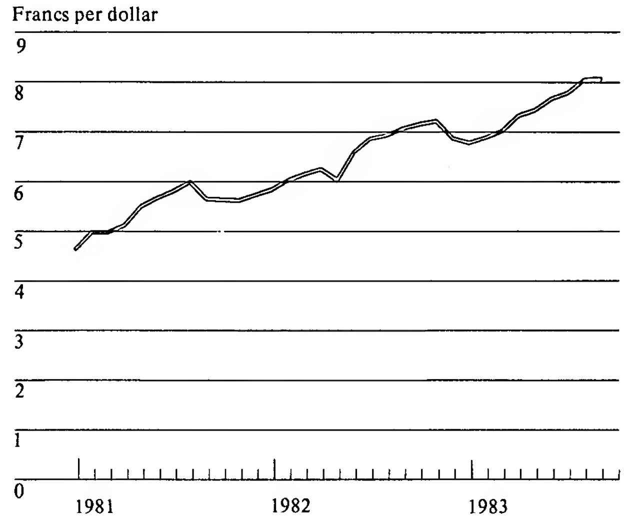
Mitterrand and the Socialists clearly are focusing on the need to win back moderate voters before the legislative elections. To do this, they are:
- Emphasizing their determination to manage the economy soundly.
- Promising to lower the tax burden in 1985.
- Admitting the mistakes of the government's first year—ascribing them to overenthusiasm and unwarranted optimism.
- Stating publicly that some cherished leftist concepts, such as class warfare, have scant contemporary validity. 25X1

Mitterrand's leftist constituency will not be forgotten, but it is not likely to be favored until the election is much nearer. With the Socialist Party at least nominally united behind a policy of moderation until the next congress in late 1985, and with the PCF likely to be called more strictly to heel if it intends to stay in the government, we believe Mitterrand has relative freedom to concentrate on the moderates. 25X1

Economic Tactics
There is no sign of any weakening in the government's determination to stay the course. According to press and Embassy reporting, the 1984 budget continues the tightening trend begun in June 1982 and reinforced in March 1983. In contrast with earlier budgets, this one projects no growth in overall real government spending. Moreover, it assumes an average inflation rate of 6.3 percent, which is at least 1 percentage point too low. This implies a decline in real terms if spending targets are met. Taxes have again been raised to respect Mitterrand's directive to limit the central government budget deficit to 3 percent of GDP and to make up an anticipated shortfall in social security fund revenues. The government's overall share of national income, which was 42.7 percent when Mitterrand took offiee, is estimated at 45 percent in 1983. It will rise, according to Embassy reporting, to 46 percent in 1984.

The government's stated goals for 1983—to limit consumer price inflation (measured from December to December) to 8.4 percent and to halve the trade deficit—were too optimistic. Subsequently, the target for the trade deficit was shifted to the end of the first quarter of 1984—four quarters after implementation of the March austerity measures rather than three.

Figure 3
France: Franc-Dollar Exchange Rates



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We believe that the adjusted target will be met, and perhaps even bettered, even though the stronger-than-expected dollar has been a complicating factor (see figure 3). As was intended, the economy has lost much of its buoyancy; imports have flattened out while French exports, benefiting from previous devaluations and stronger growth elsewhere, have been increasing. Through the first 10 months of 1983, the trade deficit was running at an annual rate of nearly 50 billion francs, compared with 93 billion francs in 1982.[2] It is likely to continue to improve during 1984 and probably will be close to balance before the year ends. 25X1

The outlook for inflation is more problematical. Prices have already risen 8.5 percent for the first 10 months of 1983 (see figure 4). The government wants to hold wage increases in 1984 to 5 percent, the same as the 25X1

[2] Comparison of dollar equivalents to the French trade deficits is misleading because of the successive devaluations of the franc and the strong appreciation of the dollar against European currencies.

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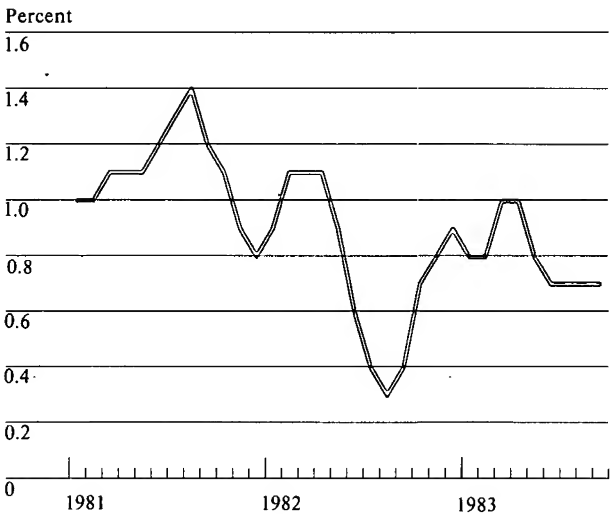
Figure 4
France: Consumer Price Inflation[a]



[a] Percent change over previous month using 3-month moving average.

[redacted]

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projected consumer price rise from December-through-December. To win labor agreement, the government must come close to its 1983 inflation target of 8.4 percent. Workers, and their unions, will be less inclined to go along with an "unrealistic" goal for 1984 if the 1983 target is exceeded by too much. We believe, however, that December-through-December inflation this year will be at least 9.4 percent—a full percentage point above the target. [redacted]

This disappointing performance may be enough to force the government to give some ground on wages, but we do not believe that Mitterrand will back down in any significant way. The government might, for example, accept private-sector settlements closer to 6 percent than to 5 percent, and it might grant civil servants a modest "catchup" for lost 1983 purchasing power when this matter comes up for discussion in February. We do not believe, on the other hand, that Mitterrand will countenance a return to past indexation practices. Press reporting indicates, to the contrary, that the government may propose that next year's programed wage increases be semiannual rather than quarterly. It also may propose that only part of a worker's salary—perhaps roughly equivalent to the minimum wage—benefit from a purchasing power "guarantee." [redacted] 25X1

The government will have some strong advantages as it negotiates with the labor unions. Despite its unsatisfactory—from the labor point of view—performance on maintaining real wages, union leaders still generally believe that a government of the left is likely to serve working-class interests better than the more conservative opposition parties. They may find it necessary to tolerate some displays of militancy, but they will probably try to ensure that any strikes do not push the government too far. The government, for its part, will not hesitate to threaten another wage freeze if labor shows itself to be too inflexible. Not least, rising unemployment, although an additional source of discontent, may also dampen the enthusiasm of workers for a severe, disruptive confrontation with the government. [redacted] 25X1

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Another devaluation of the franc within the EMS is, in our view, inevitable—the inflation differential with Bonn remains too great—but the government will probably try to carry it out "quietly" before speculative pressures require significant expenditures of foreign exchange. Paris undoubtedly will also look to Bonn to bear the lion's share of the readjustment of parities in order to mute opposition criticism. [redacted]

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The government inevitably will do what it can to balance bad news such as a fourth devaluation and rising unemployment. We expect that it will make much of the good news that is likely to surface—for example, monthly trade surpluses or low monthly price increases. It is also possible that the government will seek to repay some of the country's foreign debt as a highly visible demonstration that its policies are working. [redacted] 25X1

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Longer Term Prospects and Problems

The Mitterrand government's most severe internal and external critics give it little credit for steadfastness of purpose. They dismiss the austerity program as a tactical maneuver, and they assume that over the longer term it will be compromised out of existence under the pressures of leftist currents. They foresee a reversion to strongly expansionist fiscal policies and wholesale interference in the economy, with the inevitable consequences of inflation, capital flight, labor unrest, and falling competitiveness. The most apocalyptic critics, many representing the French and international financial communities, have foreseen a permanent decline from the ranks of leading industrial powers and a prolonged period of internal unrest. We believe these fears are exaggerated. [redacted] 25X1

Likely Policies Through 1985

The Mitterrand government appears to be on the road to repairing the cyclical damage its initial errors caused the French economy. In addition, we believe that the shift toward austerity and the concentration of economic policy making authority in the hands of moderates like Delors and Fabius signifies that Mitterrand's own conception of what a Socialist-dominated government can and should do has undergone considerable revision since 1981. Although Mitterrand has certainly not abandoned his vision of a "different" France, we believe that he and the majority of Socialists now realize that his vision must be more carefully pursued if the left is to retain the support of the French electorate. [redacted] 25X1

Nonetheless, we believe that pressure will begin to build in 1985 for an economic program somewhat better attuned to the constituency on the left. In addition to the normal risk that a democratic government is likely to expect if the domestic economy is sluggish on election day, the Mitterrand government will need to persuade leftist voters who are now "demobilized" that there is a reason to show up at the polls. It will probably look for ways to display its commitment to traditional Socialist principles that are not excessively costly—for example, honoring the Socialist Party's long-term goal of instituting some form of proportional representation. Another step we believe Mitterrand may take is to replace Mauroy and reshuffle the cabinet to give the impression that the government is taking a fresh look at its policies. [redacted] 25X1

Some reflationary economic measures are also likely to be taken, but these probably will be held within narrow limits. We believe that Mitterrand will want to avoid pushing the economy's growth too much because overshooting would risk triggering another recurrence of the "go-stop" cycle that caused so much trouble in 1981 and 1982. The level of growth possible in 1985 and 1986 will also depend on the strength of the recovery in France's major trading partners, since Mitterrand's economic policy makers are also likely to calculate that French activity must be restrained somewhat if a repetition of the import boom of 1981 and 1982 is to be avoided. [redacted] 25X1

After the 1986 Elections

Even if Mitterrand succeeds in keeping relatively on course up to the next election, he would, during his last two years as President, be left with three, interrelated longer term problems: (1) reducing the burden of servicing foreign debt, (2) stabilizing the franc, and (3) making French industry more competitive in the world economy. Logic and necessity dictate continued moderate policies to deal with these problems, but the outcome here is less certain because political will is as much an ingredient as is economic policy [redacted] 25X1

Foreign Debt. Gross external debt continued to rise in 1983, but the rapid pace of 1981 and 1982 slowed somewhat with improving trade performance. Although Paris has foreign claims equal to all but $10-15 billion of its gross debt, many of these claims are on Third World countries whose ability to repay is questionable. Mitterrand must hope that worldwide economic conditions will improve sufficiently to permit French earnings on such services as engineering and public works to take off again, and he must accept the political risk of restraining domestic demand so as to prolong the improvement in the merchandise trade balance and permit the debt to be stabilized and progressively pared down. [redacted] 25X1

We believe it likely that Mitterrand sees no practical alternative to this course of action. If he does not persevere and accept generally lower domestic growth for a protracted period, the government could eventually be compelled to borrow from the International

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Monetary Fund and perhaps, later, to ask for a rescheduling. This step would be a blow to national pride and would, we believe, demonstrate irrevocably to many Frenchmen the failure of the Socialists' management of the economy. The damage to the party's political prospects would be severe and long lasting.

Stabilizing the Franc. The problems of the franc also demonstrate the need for a longer term commitment to austerity. Each devaluation increases the cost in francs of imports and of servicing the external debt. In the long run, a stronger currency would limit imported inflation and make servicing the debt less burdensome. Success in stabilizing the franc will depend, in large measure, on making French industry more competitive in world markets so that it need depend less on devaluations for trading advantage. A stronger franc would also be, in a sense, a byproduct of the austerity program's goal of cyclical economic stability.

Improving Competitiveness. The competitive problem of French industry has been developing for some time. Burdened with high nonwage labor costs, higher than average domestic inflation, and constant government reluctance to permit reductions in the work force, French businesses have too often found their goods overpriced abroad. The Mitterrand government's initial policies made the problem worse, and the austerity program, with its higher taxes and pressure on domestic prices and profit margins, has done little to stabilize the situation.

After their initial skepticism about the weak financial position of French business, Mitterrand and the Socialists have undergone a change of attitude. Mitterrand, for example, fired Chevenement partly because the former Industry Minister's activism led him to become too involved in the day-to-day management of nationalized firms. Mitterrand now admonishes that bureaucratic meddling in the affairs of those firms must be avoided. Since taking over from Chevenement, Fabius has publicly taken the position that the government must be more flexible in its attitude toward corporate decisions on rationalizing facilities and reducing the work force. He has stressed that the government must try to shift more of the sizable budgetary resources it commits to industry away from propping up lameduck enterprises. 25X1

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We believe that Mitterrand is sincere in wanting to reduce the cost of doing business for French enterprises and to increase their share of national income so they can undertake necessary modernization. We are less certain, however, that the government will be able to develop a coherent strategy for achieving the goal. Mitterrand and the Socialists have not abandoned their concept of an industrial policy led by the public sector as the key to future success in domestic and foreign markets. Such a program requires a substantial commitment of money by the government. Although the new sense of realism we detect probably means that industrial policy goals and means will be assessed more carefully in the future—and that the needs of the private sector will figure more prominently in the government's calculations—we believe that a clash over resources is likely. To make more funds available to the private sector, the government will need to content itself with less. The result will probably be a compromise in which neither the public nor the private sector will be satisfied. As a result, French competitiveness is not likely to be revived as quickly or as fully as the government hopes. 25X1

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Implications for the United States

Because France under Mitterrand has been a strong advocate of maintaining the military balance in Europe and shares the US goal of opposing Soviet and radical Third World expansionism in the Middle East and Africa, US interests call for a strong and stable France. On balance, we believe that Mitterrand's current economic program works toward this goal by reversing policies that, if continued, would have turned France inward and led to the country's pauperization. The Socialist Party's evolution toward economic pragmatism, if it is maintained, will contribute to political stability in France by establishing the

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party as a moderate democratic alternative on the left. Although the political price of the economic lessons the Socialists have had to learn has been, and will continue to be, a heavy one, at the present time we find little evidence that social unrest will reach levels sufficient to threaten the government's stability or to force Mitterrand to abandon his course. French commentators, including some associated with the political opposition, generally do not foresee an explosion of the kind that occurred in 1968.

The United States also has an economic stake in the success of Mitterrand's current policies. His rejection of the leftist "alternative" reduces the threat of a major increase in French protectionism. In addition, the recent favorable trend toward balance in the trade account has made tougher measures to reduce imports less likely. On the other hand, we do not expect the use of administrative impediments to imports to diminish, since the government will continue to look for ways to "accentuate" the good results. Paris is also likely to continue to push the EC to follow a tougher line against third-country imports. US agricultural products may be particularly affected.

If Mitterrand's policies fail—or if the Socialists reverse themselves and revert to irresponsibly expansionist policies—there are potentially serious negative consequences for the United States. One result would be the triumph of Chevenement and the other leftist advocates of the alternative course founded on nationalist self-assertion. This would inevitably give rise to a new wave of protectionism. In its wake would come disruption of France's economic ties to the United States and its other major Western trading partners. Ultimately, France's contribution to Western security could be affected as a progressively poorer France began to lose its ability to maintain the present level of military expenditures.

Even before this stage was reached, a serious failure of Mitterrand's policies would probably lead to a proliferation of frictions in US-French bilateral relations. It is highly likely that a beleaguered Mitterrand government would try to blame its woes on a foreign scapegoat. The United States—whose policies the French have frequently blamed for the problems of the world economy—would be a strong candidate for this role. Under these circumstances, Franco-US cooperation in pursuit of common goals would become significantly more difficult and problematical.

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